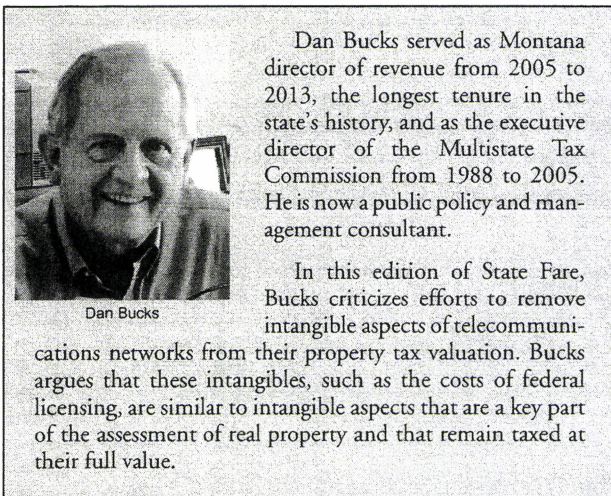


How to Ruin a Perfectly Fine Property Tax System

by Dan Bucks



State Tax Notes published, as the inaugural State Fare column, the story of how Montanans emerged from a century of corporate dominance to regain control of their own state government through the writing and adoption of a marvelous state constitution in 1972.¹ One hallmark of that new constitution was the creation of a statewide property tax system focused on achieving fairness through the equalization of property values.

Corporate rule of the state resulted in an unfair tax system that asked ordinary citizens to pay the bills that belonged to powerful economic interests. In its early development, the state was dominated by three "copper kings," each with its own complex of mines and associated properties. By the early 20th century, the Anaconda Co., an offshoot of the Rockefeller interests, consolidated those operations into a behemoth that mined copper; coordinated with the state's major power company; and owned vast forestlands, municipal water systems, the dominant chain of daily newspapers, and, reputedly, more than a few judges and legislators. It also led to political manipulation and corruption within the property tax system. One delegate to the 1972 constitutional convention labeled local property appraisal as perhaps the "greatest evil" in the Montana governmental system. Determined to end that evil, the

delegates created a statewide appraisal system dedicated to achieving the goal of equalizing the values of all property in the state.

In a potentially contradictory manner, the new Montana Constitution also celebrated popular sovereignty. Its inspiring and expansive bill of rights for citizens was accompanied by a broadly written legislative article to enable the will of the citizenry to be translated through elected representatives into public policy. The movement toward a new constitution was itself a triumph of ordinary Montanans casting off the "copper collar" that had stifled the public for decades. Despite the well-known history of powerful interests exercising undue influence, some convention delegates expressed "faith in the long-term judgement of future legislatures in matters of taxation and finance."² Thus, the convention sought to remove constitutional constraints on the Legislature so that it could fulfill the public's will.

Other delegates were less optimistic about future legislatures resisting pressures from corporations and wealthy interests, especially regarding taxation. Three advocates of tax equality who served on the convention's Revenue and Finance Committee filed a minority report opposing the open-ended authority of the Legislature to grant tax exemptions. In particular, they believed that all income-producing property should be taxed without exception. Foreshadowing the debate over intangible property, the minority report argued that tax equity required that if \$10,000 of income-producing equipment is taxed, \$10,000 of stock and bond investments should be taxed as well. Those advocates for tax equality were concerned that the unlimited legislative power to exempt property could "open the door too wide" to exemptions that would undermine tax equity.³

The delegates issuing the minority report opposing unfettered exemption power were true prophets. Signs are emerging that the fears of unwise exemptions swallowing up and negating equitable taxation are being realized. In 1999 the Montana State Legislature enacted a broadly ambiguous intangible personal property exemption that threatens the fairness of the state's property tax system. In the first instance, the new law granted potential tax advantages of

¹Dan Bucks, "Overcoming Abuses of Power: Lessons From Liberating Montana," *State Tax Notes*, Mar. 11, 2013, p. 757.

²"Revenue and Finance Proposal on Constitutional Revision," Montana Constitutional Convention, 1971-72, at 8 (Feb. 18, 1972).

³*Id.* at 33.

enormous value to a handful of corporations, primarily in the telecommunications sector. Unless eliminated or curtailed, the exemption can become an instrument for companies to undermine the full and fair market valuation of their property. The exemption could also trigger broader problems in property taxation as other taxpayers discover the inequities it creates.

But that is getting ahead of the story. To understand the role of intangible property exemptions as a tool to undermine fair market valuation of telecommunications property, one needs to understand the history of the industry's nationwide strategy toward state and local taxes in recent decades.

An Industry's Challenge to State and Local Tax Systems

The 1990s saw the telecommunications industry open several lines of attack on state and local taxation. The first effort involved seeking federal laws preempting the inclusion of the value of federal wireless communications licenses in determining tax valuations of telecommunications property.

Late in 1993 Congress drafted omnibus legislation to appropriate funds for most of the federal government. With no prior notice, no bills filed, or any hearings whatsoever, the industry secured language in the House and Senate versions to preempt state property tax laws by requiring the exemption of the value of wireless licenses from property tax assessments. The language on that point differed in the two bills. The Multistate Tax Commission discovered the preemptions hidden in those bills — one more than 800 pages long and the other more than 1,000 pages — in sections with non-matching catchphrases veiling the preemption language.

The MTC persuaded the conference committee on the omnibus appropriations bill to drop that preemption language. It also successfully resisted similar, more visible subsequent efforts. The telecommunications industry also petitioned the Federal Communications Commission to adopt rules to prohibit states from including wireless licenses in property tax valuations. Again, the MTC was successful in turning back that effort.

As a matter of context, there does not appear to be any other industry in recent decades in which a few large companies have undertaken such broad-ranging challenges to state and local property, sales, and income taxes as those arising from the telecommunications industry. That industry secured federal preemption of state and local sales taxes on Internet access charges — the Internet Tax Freedom Act — a unique preemption under which Congress selected a single product from the consumer marketplace to exempt. With mixed results, the telecom industry also resisted market sourcing of receipts for corporate income apportionment purposes that several states have undertaken to curb profit shifting and tax avoidance by the industry.

The persistence of oppositional efforts by telecommunications companies toward state and local taxes is disappointing in light of the benefits that that economically successful and technologically advanced industry secures from state and local governments. Public education produces a workforce and an advanced consumer society that supports both the supply of and demand for telecommunications. Public safety, order, and the legal framework for commerce provided by the states make national communications networks possible — and more profitable through enhanced operational synergies and economies of scale. State and local governments are themselves direct consumers of telecommunications services, providing a base of demand for the industry. While the industry complains about right-of-way fees, it is hard to imagine an advanced telecommunications industry in a society with a primitive transportation system of trails and muddy tracks. The industry enjoys the benefits from an advanced society but seeks to significantly reduce payments for state and local public services that make that society possible.

Returning to the detailed property tax issue, with the federal preemptions on property valuation blocked, the industry turned its attention to lobbying states directly to exempt the value of FCC wireless licenses or intangible property in general from unit valuation. The industry has had varying degrees of success in securing intangible exemptions in numerous states.

The issue is of no small practical consequence. In Montana the telecommunications industry suggested to the Department of Revenue during my tenure there that the intangible exemption should translate into a reduction in its property valuations of up to approximately 70 percent of existing valuations.

The Suspect Case for Exempting Intangibles From Unit Valuation

As noted, the case for exempting intangible assets from unit valuation of networked properties is of relatively recent vintage — being pressed forward largely by the telecommunications industry in the last two decades.⁴ Unit valuation of network properties is much older than that — dating back to the days following the Civil War when networks of railroads and telegraph lines spread rapidly across the nation.

The methods of networked property unit valuation have evolved over the last 125 years or so but have generally encompassed all of the interdependent elements of those networked properties both tangible or intangible. Pulling out one or more elements of an integrated property can often substantially undermine fair market valuation of that

⁴The telecommunications industry's arguments for an intangible property exemption are summarized in the document "Property Taxation on Communications Providers: A Primer for State Legislatures," National Conference of State Legislatures Executive Committee Task Force State and Local Taxation (Nov. 2015).

property. Indeed, courts across the land, including the U.S. Supreme Court, have sustained unit valuation of networked properties as an equitable method of achieving a full and fair market value for those properties.

The term “networked properties” applies to integrated property that crosses county and state boundaries and that performs transportation, communications, and electrical generation and distribution functions. States do not limit unit valuation to network properties. Although not often explicitly identified as such, typical methods of valuing residential and commercial property are also a de facto form of unit valuation. The primary difference between unit valuation of networked properties and residential and commercial property is that the former do not exist within a single jurisdiction. Unit valuation of networked properties is also not limited to rate regulated industries. Indeed, when unit valuation of networked properties was first developed after the Civil War, it was applied to industries before they were rate regulated and later to electrical generation companies operating in deregulated markets.

The observation in the minority report of the Montana Constitutional Convention’s Revenue and Finance Committee that all income-producing property should be equally subject to tax regardless of the type or form of that property should be the yardstick for evaluating the exemption arguments. From that perspective, whether businesses use varying mixes of tangible or intangible property is irrelevant if all these categories are taken into account for tax purposes to the extent possible. Further, if non-income-producing property is also taxed, such as dwellings, the same standard should apply.

In that context, one of the main arguments advanced by the telecommunications companies for the exclusion of intangible assets from their valuation is that they purchase valuable (and thus expensive) FCC licenses to provide communication services. That is an absurd argument. It would be the same as railroads arguing that because they must purchase or rent valuable (and thus expensive) locomotives and other rolling stock to provide transportation services, their locomotives and rolling stock should be exempt from the valuation of the railroad. Or the owners of large mansions in the best part of town arguing that the elements of size, architectural design, historical significance, and location (the latter three being intangible attributes) should be exempt from the market value of their homes — solely because those intangibles are the primary source of the value of the homes compared with the homes of lesser value in the community. Or the owner of a retail store in the best market location in town that is also well protected by local police and fire departments arguing that the market value of that store should be reduced by the economic value of its business location and the perceived public safety of the store and its environs.

Because a business owns a lot of one type of valuable property does not entitle it to an exemption for the type of property that it predominantly owns. There is no principled

basis for that argument. It is negated by the higher principle that all income-producing property should be subject to taxation to the degree feasible.

But doesn’t that place telecommunications companies with valuable intangibles at a disadvantage compared with other enterprises or taxpayers? That argument is based on the false contention that other businesses or taxpayers are subject to taxation solely on their tangible assets, but not on their intangibles. In fact, valuation methods typically capture the value of intangible assets or sources of value that are integral to and embedded within the property owned by those other taxpayers. The intangibles exemption being sought by the telecommunications industry would create an unfair advantage for that industry over other businesses and taxpayers — and would improperly shift the cost of services that should be paid by telecommunications companies to others.

Unit valuation is not reserved for network properties alone. Commercial businesses and residences are also valued as assembled units. A contemporary building is a system of both diverse physical components and intangible values, as is a telecommunications operating property, and the building is valued in a way that captures all of those sources of value that are integrated into that structure. The major intangible asset for most buildings is its location. For a commercial building, that might be a function of its proximity to desired customers and markets, accessibility to suppliers or workforce, attractiveness of its design, and its perceived safety. The better those location and design values, the higher the property’s value.

The analog to those commercial property location factors for a wireless telecommunications company is the FCC operating license. That license essentially determines the economic location of the company in the marketplace. Further, the license is integral to the company providing communications services, just as an accessible location is integral to the functioning of a retail store. Without the license, there really is not an operating telecommunication property useable and accessible by consumers in the wireless marketplace. If one removes the value of the license, one destroys most of the value of the operating property. Similarly, if a building’s location becomes inaccessible to its customers and suppliers, the value of the building disappears as well.

However, if the intangible locational value of a commercial building or a residence remains a factor in its property tax value, but the value of the FCC communications license is exempt, the telecommunications company gains an unfair advantage over those other taxpayers. The other taxpayers will pay public service costs that should be charged to the telecommunications company.

What about the goodwill that a telecommunications network earns through the pattern of relationships over time with its customers, suppliers, and workforce? The comparable intangible sources of value for residences are the human-created neighborhood characteristics that define an

area as a good place to live. That includes long-term community stability, economic relationships, quality public services, and various community amenities. That community goodwill contributes to the property values of a neighborhood or community. Thus, community goodwill is incorporated into assessed values, and business goodwill should be treated the same for tax purposes.

What about the assemblage and design of a telecommunications property?⁵ Again, commercial buildings and residences are not taxed as unassembled stacks of buildings on nondescript unimproved vacant land. Residential and commercial buildings are complex systems composed of diverse elements that are valued as fully assembled operating units comparable to the unit valuation of networked properties. Through the application of human and mechanical work, the diverse and complex components of a building are held together by embedded energy and a building design. That embedded energy and design are intangible assets captured and taxed in the typical residential and commercial and property tax valuation process. Construction and architectural design and the drawings that guide assemblage of a building are effectively valued as well. The better the design, the higher the building's market value. The intangible element of design and assemblage should likewise remain subject to taxation for a telecommunications company as it is for other business and residential property.

What about the cost of the assembled workforce that maintains, repairs, and operates the telecommunications property?⁶ Shouldn't that be exempt as an intangible value? The answer is no. The owners of commercial and residential buildings are not provided an exemption for the costs of maintaining, repairing, and operating their buildings, so that same cost should not be exempt for the telecommunications companies either.

The list can go on. For virtually every factor that gets identified as an intangible asset or source of value for a telecommunications operating property that its owners may want to exempt from taxation, one can find a counterpart for other properties under current practices that remains subject to tax.

The most telling refutation of the telecommunications industry exemption arguments comes from its own advocacy of combining the intangible exemption with an alternative method of valuation labeled "replacement cost new less depreciation," or RCNLD — an acronym often repeated as an industry mantra. Why replacement cost new?

⁵In my experience, industry advocates have at various times raised the issue of exempting the "assemblage value" of networked properties from taxation. As to matters of design, SB 394 introduced in the 2015 Montana State Legislature proposed adding engineering drawings to the intangibles exemption.

⁶Again, various industry advocates argue for an exemption for an assembled workforce. SB 394 in the 2015 Montana State Legislature also proposed that exemption.

Because electronic equipment used by the industry typically declines in value, so using it as a starting point cuts its property valuation. More importantly, RCNLD, when coupled with a broad intangibles exemption, is essentially a list of unassembled parts depreciated. It would be the equivalent of valuing a house as an unassembled pile of construction materials on a generic, unimproved plot of land. A parts list does not constitute a fair and equitable reflection of the market value of an operating telecommunications property. Further, because the list of highly specialized parts and their associated costs are really only known to the telecommunications company, the company would essentially value its own property for tax purposes, handing the list over to the property assessor who would have little ability to independently determine the property values.

There are other practical problems of intangible property exemptions. Such laws, of which the current Montana statute is an example, contain nebulous and facile language that cannot be translated into definite, well-determined valuations.⁷ In the hands of talented litigators and lobbyists, such language is a source of mischief, invitation to abuse, and a target for future expansion at the expense of other taxpayers.

Preserving Equitable and Stable Property Taxation

There is no compelling case for a blanket exemption of intangible personal property values from taxation. Intangible property is taxed in the context of commercial and residential real property — and exempting it in comparable circumstances for networked properties is fundamentally unfair to real property owners who must pick up the tab for the exempt intangible personal property.

The resulting tax shift and perceptions of inequity could lead to further unintended consequences ranging from increased public resistance to financing services from property taxes to various political or legal challenges to the property tax system. Among those consequences could be the discovery by homeowners and commercial property owners that their property valuations also reflect contributions from intangibles. Residential and commercial property owners could seek, on grounds of fair and equal treatment, the removal of intangibles, such as location, from their valuations as well. In that case, an intangibles exemption originating to serve the interests of primarily one industry could become the thread that other taxpayers could pull to unravel the fabric of an otherwise equitable property tax system. That unraveling could be highly disruptive of some state and local fiscal systems.

To prevent the ruin of equitable and stable property tax systems, legislatures should maintain the equal taxability of all income-producing property and residential property to the degree feasible. Because market valuation typically captures both the value of tangible and intangible property,

⁷See 15-6-218, Mont. Codes Ann. 2015.

legislatures should take one of two approaches to intangible property exemptions. They should either eliminate all exemptions for intangible property or statutorily exempt only intangible property that can be removed without diminishing the value of personal or real property with which it is associated. Under the second option, intangible property the value of which is interdependent with or integral to tangible real or personal property would remain taxable.

In 2010, while I served as director, the Montana DOR addressed what it viewed as the conflict between the constitutional and statutory mandate to equalize the market values of all property and an ambiguous intangible personal property exemption that undermined the equalization of market values. The vehicle for resolving that conflict of laws was a rule that required, as a key feature, the exemption to apply if the removal of the intangible property would not impair the market value of an operating property unit. The

Montana Supreme Court invalidated that rule on the basis that it was inconsistent with the language of the intangibles exemption.

While I believe the court did not fully consider the need to harmonize conflicting laws, the fact is the court's decision was a legal ruling, not a policy decision. It is fully subject to legislative change. As a matter of policy, legislatures should, if they allow any intangible exemption, limit that exemption to property that, if removed, does not impair the value of the tangible real or personal property with which it is associated. That is a critical means of preventing an intangibles exemption from weakening the fair and equitable valuation of all property at market value within a state. If legislatures fail to curb intangibles exemptions, they risk serious, long-term consequences for the equity, stability, and financial adequacy of their property tax system. ☆

Crossword Puzzle Solution

